

VZCZCXR00088
PP RUEHDBU
DE RUEHTA #1456/01 1110409
ZNY CCCCC ZZH
P 210409Z APR 06
FM AMEMBASSY ALMATY
TO RUEHC/SECSTATE WASHDC PRIORITY 5020
INFO RUEHAAH/AMEMBASSY ASHGABAT 6956
RUEHKB/AMEMBASSY BAKU 0666
RUEHBJ/AMEMBASSY BEIJING 1253
RUEHEK/AMEMBASSY BISHKEK 7517
RUEHDBU/AMEMBASSY DUSHANBE 1695
RUEHIL/AMEMBASSY ISLAMABAD 2035
RUEHBUL/AMEMBASSY KABUL 0178
RUEHMO/AMEMBASSY MOSCOW 1215
RUEHNE/AMEMBASSY NEW DELHI 0315
RUEHNT/AMEMBASSY TASHKENT 7483
RUEHSI/AMEMBASSY TBILISI 2196
RUEAIIA/CIA WASHDC
RUEBAAA/DEPT OF ENERGY WASHDC

C O N F I D E N T I A L SECTION 01 OF 03 ALMATY 001456

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DEPT FOR EB/ESC; SCA/PO (MANN); SCA/CACEN (MUDGE)

E.O. 12958: DECL: 04/19/2015

TAGS: ENRG EPET KZ AF PK

SUBJECT: KAZAKHSTAN: A/S BOUCHER DISCUSSES BUSINESS CLIMATE, REGIONAL INTEGRATION WITH BUSINESS LEADERS

Classified By: AMBASSADOR JOHN ORDWAY FOR REASONS 1.4(B) and (D)

¶1. (C) Summary: SCA Assistant Secretary Boucher discussed Kazakhstan's business climate, regional economic integration, and oil and gas infrastructure projects on April 10 with representatives of American companies operating in Kazakhstan. While acknowledging that their companies were thriving in Kazakhstan, especially in the retail and banking sectors, the executives pointed out obstacles to doing business in Kazakhstan, including widespread corruption; a lack of transparency, particularly in tax law and collection; the Government of Kazakhstan's growing tendency to "criminalize" civil disputes; and a shortage of technically skilled Kazakhstani workers. A/S Boucher described the U.S. Government's vision for regional infrastructure integration, identifying the electricity sector as the most promising in the short-run, and pointing out the eventual benefit to Central Asian countries of tapping the "near-infinite" Indian market. AES representative Dale Perry told A/S Boucher that it was "entirely economic" to sell Central Asian electricity to Pakistan, and described AES's involvement in generation and transmission projects to that end. A/S Boucher and oil executives also discussed current and next-generation oil and gas pipeline projects. End Summary.

¶2. (U) Meeting Participants: SCA A/S Boucher, Senior Advisor Caitlin Hayden, Ambassador Ordway, Commercial Officer Mitch Auerbach, Energy Officer Jim Loveland (Notetaker), Gil Ankenbauer (Chevron), Dan Connelly (Citibank), Paul Dennard (ExxonMobil), Courtney Fowler (PriceWaterhouseCooper), Hakim Janah (ConocoPhillips), Ken Mack (AmCham), Meltem Metin (Coca Cola), Dale Perry (AES), Andy Peterson (Proctor & Gamble), Marla Valdez (DentonWildeSapte).

Weaknesses in the Business Climate

¶3. (C) While acknowledging that their businesses were thriving, especially in the banking and retail sectors, the business leaders used their meeting with A/S Boucher to describe challenges to doing business in Kazakhstan. There was widespread agreement, for example, that Kazakhstan suffered from "endemic" corruption. However, different types

of corruption could be distinguished: at low-levels, business owners often faced direct appeals for payoffs from local officials. At higher levels, however, corruption often took the form of using connections to Nazarbayev's family as a virtual exemption from regulation and taxation; to not have those connections meant suffering a comparative disadvantage.

A/S Boucher asked if American companies were exempted from most bribery demands. The local Coca-Cola representative, Meltim Metin, acknowledged that the Foreign Corrupt Practices Act did help shelter American companies somewhat, but noted that Coca Cola was still "tested" when it expanded its business into new markets.

¶4. (C) The executives then described a second set of problems related to a lack of transparency in tax law and collection. The Proctor & Gamble representative explained that his company had suffered several "nasty tax audits" over the years, but had ultimately won all the cases in court. Smaller enterprises, however, often did not have the means to engage in prolonged legal battles -- many of which would drag on for years, without resolution. The executives identified several factors which invited the abuse of tax audits, including hastily-drafted tax law which even the Ministry of Finance could not definitively explain; the fact that local tax collection offices were assigned revenue collection "targets" which had no basis in law; and the fact that no effective check -- other than the Presidency -- existed to limit the power of the Financial Police and the Procuracy.

¶5. (C) Several business leaders expressed alarm over the Government of Kazakhstan's growing tendency to "criminalize" civil disputes. DentonWildeSapte's Valdez explained that, according to Kazakhstani law, the head of a company or the company's lead accountant could be held criminally liable for

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audit assessments exceeding \$12,000. Only recently, however, had the government begun to use this law as leverage against companies embroiled in unrelated disputes with the government. Several executives noted that the Government of Kazakhstan's tendency to criminalize civil wrongs had affected their day-to-day operations, as many local employees were now afraid to sign documents or make critical accounting decisions, for fear of future criminal liability.

Institutional Issues: Judiciary, Education

¶6. (C) DentonWildeSapte's Valdez described Kazakhstan's judicial system as being of "mixed" quality. Lower-level judges, especially those outside of Almaty, often accepted bribes or succumbed to pressures from local officials, she said. On the other hand, the Supreme Court (which functions as a general appellate court in Kazakhstan) often issued well-founded rulings. Valdez characterized Kazakhstani society as increasingly litigious, as the volume of commercial transactions increased. Few contracts allowed for either local or international arbitration, she noted, so most day-to-day problems were resolved either via negotiation or in court.

¶7. (C) The business leaders identified education and training as another issue of concern, describing their difficulty in hiring and retaining technically skilled employees. Employees who were sent abroad on assignment often did not want to return; when technical employees did return they often wanted top management jobs. Valdez warned that Kazakhstani university students were flocking to jobs in business or real estate, rather than the technical professions. Due to low salaries, the teaching profession was attracting even fewer students, she said -- a trend which would lead to serious long-term problems.

Banking: A Kazakhstani Strength

¶8. (C) Citibank Kazakhstan President Dan Connelly told A/S Boucher that Kazakhstan's banking system was "good," unlike most of the Former Soviet Union. Kazakhstan's 34 banks operated on a "pretty level playing field," with rapid rates of growth. Asked whether certain banks were privileged by virtue of having close ties to the regime, Connelly acknowledged that, of the top ten banks, all were owned and managed by well-connected people. However, Nazarbayev's family owned only two of the top-ten banks, and of the top three banks, two were associated more with the opposition than with the government. Connelly pointed out that the top three banks held 60% of the system's assets. Their size, he concluded, gave them a measure of freedom to criticize the government.

Diversifying the Economy

¶9. (C) The meeting participants discussed prospects for diversifying Kazakhstan's economy away from oil. The ConocoPhillips representative identified Kazakhstan's push for a domestic petrochemical industry as one attempt at diversification. PriceWaterhouseCooper's Fowler remarked that the draft 2007 tax cuts, if passed as drafted, would create important incentives for investment beyond the oil sector. Ambassador Ordway added the field of agricultural processing held potential, and later observed that the Kazakhstani Government intended to use the National Oil Fund as an instrument of diversification, by investing its funds in high-tech firms abroad. These firms, in turn, could be used as a base from which to develop a domestic high-tech industry.

Regional Economic Integration

¶10. (C) Asked to describe his vision of regional integration,

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A/S Boucher told the invitees that he was convinced that "eventually, it has to happen." Governments were already envisioning the connections; companies would eventually follow. While stability in Afghanistan was a key, A/S Boucher acknowledged, it wasn't as big an obstacle as many thought. Pipelines, for example, "exist in many other unstable places." A/S Boucher remarked that the "most viable" project at the moment appeared to be the generation of electricity in the North for transmission South. Improving road linkages was also important, though made difficult by the terrain and Uzbekistan's central location. The real benefits of integration would be realized, he concluded, when area countries were able to access the "almost infinite" Indian market.

¶11. (C) AES Country Manager Dale Perry told A/S Boucher that, with power prices in Pakistan five times higher than in Kazakhstan, the economics were favorable for generating electricity in Central Asia for export south. To that end, AES was interested not only in hydropower projects in Tajikistan, but also in the repair and construction of transmission lines linking the Tajik grid to Afghanistan and, eventually, to Pakistan. Ultimately, Perry said, he foresaw the construction of a North-South direct current transmission line which would allow coal-generated electricity from Kazakhstan to offset seasonal shortages in Tajik and Kyrgyz hydroelectricity, and vice versa. However, Perry added, "power should first flow South." To that end, the USG could help by ceasing to subsidize diesel fuel consumption in Afghanistan; with the subsidies, imported electricity was not competitive. Perry noted that the Kazakhstanis, as well, had expressed interest in investing in regional electricity projects.

Oil and Gas Pipelines

¶12. (C) A/S Boucher asked the oil executives what proportion of Kazakhstani hydrocarbons transited Russia, and what could be done to lessen that dependence. Chevron's Ankenbauer acknowledged that dependence on Russia was a serious problem, pointing out that, with Tengiz "second-generation" production volumes coming on-line, and CPC expansion negotiations still blocked by the Russians, Chevron would be forced in the short-run to export large volumes of Tengiz oil by rail. ConocoPhillips' Janah noted that early Kashagan oil would be barged across the Caspian to the BTC pipeline -- provided ongoing Kazakhstani-Azeri negotiations over Kazakhstani access to the pipeline were resolved. A Trans-Caspian oil pipeline would be a better solution, he added, but had been blocked by Russian opposition and unresolved Caspian delimitation issues. The group then discussed other, less-attractive export options: the second of three stages of an oil pipeline to China had recently been completed, but that export route provided the Kazakhstanis with only a single, monopsonistic buyer. Total and Shell were still exploring a possible pipeline to Iran; however, U.S. opposition and questionable economics would likely keep the project from being realized. Finally, the oil executives voiced doubt that an oil pipeline could be constructed directly from Kazakhstan to Pakistan or Afghanistan, due to the challenging terrain.

¶13. (U) A/S Boucher has cleared this message.
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